

The gains, the grey and the gremlins of FSR

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Good morning. It is my pleasure to talk to you this morning to share with you ASIC's views on FSRA and a number of topical issues for the Banking and Finance Sector that have arisen post FSRA implementation.

As many of you will have travelled the Financial Services Reform implementation road with ASIC over the past two years, I'll start by touching on the 'fallout' from FSRA and life post March 11. I'll also cover some of the key issues that have emerged in Financial Services and recent guidance to address some of those issues, and look at our upcoming consumer challenges.

For the past couple of years we have had a major focus on implementing FSRA, as have you. Can I take this opportunity to acknowledge the meaningful dialogue we have had with industry over that period. I believe FSRA has been a good example of how the regulator and industry can consult and hopefully improve the position of all parties while maintaining the Government's intent in the legislation.

I'll turn now to FSRA implementation - almost 4 months on.

FSRA: The final picture

As at midnight on 10 March 2004, we had issued 3738 licences. Since then we have issued another 242 licences with an additional 166 applications under assessment. This far exceeds our predicted level of activity in the period immediately following end of transition – and it currently shows little sign of abating.

Of the total 3980 licence holders at mid-July, the largest licensed industry sector is general insurance, which accounts for 23.2 percent of the AFSL licensed population – followed by financial advisers at 21.3 percent. Deposit takers account for 4.1 percent of licensees and conglomerates 2.9%.

By far the largest number of licensees (44%) are based in NSW, with 27% in Victoria, 13% in Qld, 9% in WA and a smaller representation across SA, Tas and ACT.

In accordance with expectations, the legislation is still bedding down and in many respects this makes it difficult to define whether the legislation has met its intended objectives. For example, we considered over 1,000 FSR-related applications for relief and issued approximately 80 FSR-related class orders during the two-year transition period. We granted both class order and individual relief to enable the new regime to apply appropriately, having regard to the breadth and diversity of financial services and financial products captured by the new regime. Where relief has been granted it has been on conditions that aim to achieve similar market integrity and consumer protection outcomes.

We know that industry is still grappling with particular FSRA issues – this is evidenced by the queries still coming in to project office, the number and complexity of issues raised at industry liaison fora and the fact that we continue to receive on average ten applications for relief each week. We expect this will continue as the industry copes with the practical outworkings of the new regime. We propose to issue an information release that covers the key types of relief that has been granted over the past six months, to provide guidance to industry in the areas addressed.

Ongoing Compliance

While we continue to deal with relief applications and industry issues, we have now turned our focus to compliance with the new regime.

For those of you who are licensed, the FSR regime comes with ongoing compliance obligations you need to satisfy. These include maintaining your organisational capacities, notifying ASIC of changes to licensee details, including change of responsible officers, compensation arrangements and dispute resolution processes and authorised representatives, reporting breaches and meeting disclosure requirements.

One of our key regulatory responsibilities at the end of implementation was to ensure, to the best of our ability, a compliant industry. Our priority for the 6 months from end of transition to September is to ensure that there are no persons operating a financial services business without a licence (including some superannuation trustees) - we will be encouraging these people to obtain a licence.

Our next priority will be to target high-risk licensees for surveillance. We will be doing this by reviewing the detailed material applicants have lodged with ASIC, looking at any complaints

history, taking into account trends from the complaints resolution scheme as well as relying on information and intelligence from industry. We carry out compliance checks to promote compliance; detect misconduct; identify systemic issues and confirm intelligence.

Our compliance checks may be desk based or site visits.

ASIC Verification Visits

We have also conducted 284 verification visits over the last twelve months. These checks are used to verify statements made in an AFS licence application concerning a licensee's compliance arrangements and identify the type of compliance measures AFS licensees have in place in order to meet their ongoing licence obligations. We are interested in what is in place (based on statements made in AFS licence applications) and whether a sample of these processes is in use.

The information gleaned from our visits serves multiple purposes. In particular, we use it to educate AFS licensees about their licensee obligations; develop our own understanding of how licensees conduct their business; provide an early warning system for licensees that may be targeted for a reactive visit and to raise standards in the industry.

We select licensees randomly and are covering all types of industry groups who provide financial services under an AFS Licence. We will be taking into account the findings of the verification visits carried out to date, which highlight a number of deficiencies. In over 40% of visits undertaken, issues were identified requiring licensees to review and update their compliance procedures.

In many cases, the matters that cause us concern are not particularly complex: they are straightforward, basic compliance activities that have not been properly attended to. Example of concerns include no formalised compliance monitoring or reporting process, cashflow projections not being maintained, absence of breach and complaints registers, poor training records, risk management plans not covering all business risks (such as AFS Licensing obligations) and inadequate professional indemnity cover.

We need to be satisfied that compliance procedures are up-to-date, are tailored to the licensee's business activities and that licensees have a basic understanding of their AFS licensing obligations.

Breach notifications

We have made it clear that we will take into account whether an entity is genuinely attempting to comply with the law. Where we consider non-compliance is deliberate, we will treat such breaches seriously and will use all the regulatory options available to us, including court action and licence revocation. This goes both for companies that continue to operate while unlicensed and those that fail to meet the responsibilities and obligations imposed by the Corporations Act.

Technical breaches

ASIC is aware that some AFS licensees may be in technical breach of their licence because they do not have all of the licence authorisations they need to carry on their financial services business.

ASIC will not take any action if a licensee is in technical breach of their licence. However, we encourage these licensees to apply immediately for a variation to their licence to limit the time of any technical breach.

Significant Breaches

Under the Corporations Act (s 912D - as amended by the FSR Amendment Act 2003) a financial services licensee must judge whether to report a breach or likely breach to ASIC as 'significant' having regard to a number of factors:

- the number or frequency of similar previous breaches
- the impact of the breach or likely breach on the licensee's ability to provide the financial services covered by the license
- the extent to which the breach or likely breach indicates that the licensee's compliance arrangements are inadequate
- the actual or potential financial loss to clients or the licensee arising from the breach or likely breach.

...and any other matters that may be prescribed by regulation. (At the moment there are no others.)

Rectification of the breach and/or compensation to clients does not necessarily mean that the breach is not significant. However these matters might affect ASIC's response, and we may wish to test whether the breach has in fact been rectified and the compensation

was in fact adequate. Other factors that might affect our response would be the extent to which the licensee is open and cooperative with ASIC.

In order to meet its obligation to report significant breaches we would expect licensees to maintain a register of all breaches identified and to document the reasoning behind their judgement as to whether a particular breach is reportable or not.

ASIC is soon to issued guidance on breach notification. The purpose of the Guide is to provide practical guidance to licensees on when they are required to report breaches to ASIC. The general tone of the Guide is to encourage licensees to report breaches and tends towards an "if in doubt - report" position to ensure the obligation is fulfilled. The body of the guide is set out in question and answer format and addresses such areas as what 'likely to breach' means, what 'significant breach' means and gives examples of both. Without going into detail, the guide expands on the factors to which the licensee must have regard when considering if there has been a significant breach. Guidance is also provided on matters such as the arrangements a licensee should have in place to record breaches and how to report a breach.

This guide has been eagerly anticipated by industry and I encourage you to access the guide via ASIC's website.

We have worked closely with industry in preparing for and understanding FSRA. The Commission has committed to continued consultation with industry and consumer groups over the next 12 months as FSRA beds down. This interaction with industry and consumer has, to date, focused on identifying and, where possible, giving further guidance and appropriate relief. In addition, we will continue to provide support to market participants through our FSRA Project Office. We are already participating in ongoing industry/regulatory consultation on outstanding FSRA issues, many of which concern disclosure issues and disclosure documentation.

Disclosure

Disclosure is intrinsically linked to people's ability to understand the information they are presented with. Effective communication about financial products and services needs to be addressed at both ends. While we need to work to raise people's ability to understand their finances, that does not do away with need for industry to ensure that product information is not overly complex and as easy to understand as possible.

The FSRA places great importance on product disclosure in introducing a single disclosure regime for all financial products. One of the central aims of the FSR disclosure regime is to ensure consumers have sufficient information to help them make informed choices when considering the purchase of financial products and services. The law states that the information contained in disclosure documents must be worded and presented in a clear, concise and effective manner.

We are aware that some licensees are finding difficulty in producing documents that satisfy these requirements. Some industry participants have told us that they are being advised to produce lengthy documents in order to comply with the legal requirements. This is not what we would expect to see under the law, and it is not helpful to consumers. ASIC sees disclosure under the new law as a consumer-centric regime focusing on the consumer's information needs. We discourage licensees from providing their clients with documents that are overly long and contain unnecessary information.

We know this is a difficult area and we do understand that many financial service providers will take a conservative approach and produce documents that are "boiler plate". It is important, however, that we get the balance right between providing all the information that the client needs with the requirement for the information to be clear, concise and effective.

We have already issued guidance about disclosure documents in Policy Statement 168, Disclosure: Product Disclosure Statements and Policy Statement 175 Licensing: Financial Product Advisers – Conduct and Disclosure. Policy Statement 168 sets out the Good Disclosure Principles, which are designed to help industry produce clear, concise and effective documents that satisfy statutory requirements.

Commission Disclosure

Disclosure of commissions has been an ongoing issue for most sectors of the financial services industry for some time and has been given due attention by both ASIC and the Government. In mid-June, ASIC issued its revised fee disclosure model for use in Product Disclosure Documents. Also around mid June, the Government released its fee disclosure package for superannuation and managed investment products.

ASIC's revised template was issued after stakeholder consumer testing of the initial model and a further consultation process with industry stakeholders. The fee disclosure model sets out

good practice for the disclosure of fees and costs in a discrete section of a PDS and aims to cover all financial products with an investment component. The intent of the model is to improve disclosure of fees through adopting the good disclosure principles set out in Policy Statement 168 (Disclosure: Product Disclosure Statements (and other disclosure obligations)); to help product issuers meet the Product Disclosure Statement requirements of the Corporations Act; and to improve consumer comprehension of the fees and costs associated with investment products and the services covered by each fee. We have included a single 'see at a glance' table containing a reference to all fees and costs, both direct or indirect and stated in dollars or translated to dollar terms, to assist with comparability.

In its Disclosure Package, the Government has announced its intention to mandate the use of the ASIC Fee Template through regulations, for use in both PDSs and Periodic Statements. The Government also intends to mandate the use of a single-figure fee comparison table in PDSs. The model proposed expands on the International Organisation of Securities Commission's model, thus keeping in step with our international counterparts.

Dollar Disclosure

You would also be aware that the Government has issued proposed dollar disclosure regulations for public consultation. The draft regulations provide for a clear transition period up to a 1 January 2005 implement date. These regulations should provide greater certainty as to the way in which the requirements will operate and the method of applying to ASIC for relief. We know that the banking industry is awaiting policy and guidance from ASIC about how it will administer the regulations and we will shortly issue a Policy Proposal Paper indicating how ASIC will exercise its discretion in respect of entities who will apply for relief for not being able to meet the deadline.

Contributory Mortgage Products

While on the topic of disclosure, I'll also make reference to an upcoming FAQ in response to queries raised by the operators of contributory mortgage schemes as to how continuous issuers of financial investments and contributory mortgage products comply with the Product Disclosure Statement disclosure obligations of Pat 7.9 of the Law.

Essentially, you have two options to meeting this requirement: you can prepare a two-part PDS, where the initial part provides generic details relating to the operation of the scheme or set out the core information relating to the basic terms and conditions of the

scheme. The second part provides the transaction specific information relating to a particular mortgage or loan transaction or any information that is likely to change frequently.

Both the first and second parts of the PDS must be given at the same time. This may raise issues of costs and administrative burden, in which case the supplementary PDS option may be preferable. In this case the generic information is provided up front in a PDS and the mortgage-specific information in a supplementary PDS. The same generic PDS can be used in combination with numerous mortgage-specific PDSs. In first instance, the PDS and SPDS must be provided to the client together, but where you know that an existing client has previously received the PDS with all the update generic information about a mortgage scheme it will not be necessary to give the generic PDS every time an SPDS is provided. The SPDS must however contain a statement that it is to be read with the PDS.

Contributory mortgage schemes do not require relief to provide two-part disclosure, due to the flexibility of the PDS provisions.

The Frequently Asked Question contains further information than set out above, and can also be viewed on ASIC's website.

BANKING ISSUES

In a number of instances, ASIC has recognized the different circumstances applying to the banking industry and has granted relief in a number of areas. These include:

Loyalty programs

In February this year, ASIC's issued an information release, which indicated that relief under ASIC's interim approach for loyalty schemes will be considered on a case-by-case basis where ASIC is satisfied that:

- the scheme is either designed to reward customer loyalty or reasonably likely to promote spending on the goods and services of the issuer
- the scheme includes a reward redemption facility whereby clients are allocated points as a result of using, or spending on, the issuer's goods or services, whether or not a monetary value is expressly attributed to the points

- the points allocated to a client can be used by the client to make payment, or cause payments to be made, for goods or services, to obtain a discount on goods or services or to obtain points for other loyalty schemes ('reward redemption'); and
- clients can only make a cash contribution in exchange for points where they are making a specific reward redemption and the number of points exchanged for cash does not exceed 20 per cent of their existing points used for the reward redemption

The interim relief will only apply until 30 June 2005 allowing the Federal Government and ASIC to adequately consider technical aspects of the application of the FSR licensing and disclosure regime to loyalty schemes that constitute or include a non-cash payment facility. This will include consideration of any practical compliance problems and whether any permanent ongoing relief is appropriate.

ASIC will consult with industry before its policy position on loyalty schemes is finalised. The Policy Proposal Paper is scheduled for release in September/October with the final policy likely early next year. Certain conditions will attach to the relief.

Relief for Agency Banking Services

We have also issued Class Order relief to assist Australian ADIs that use agents to provide their banking services under the Law, in relation to basic deposit products. We're aware that many ADIs use Australia Post, chemists, newsagents and other outlets to provide basic deposit products. As helping to open a bank account may be 'arranging' within the meaning of the law, and thus would require an AFSL, our relief allows agents appointed by ADIs to provide this service without the need to be formally licensed or appointed as an authorised representative of the bank. This means that retail clients will continue to have access to basic deposit products, particularly in areas where there are few or no branches, while still getting the same standard of consumer protection they would get at a branch of the ADI. The ADI will be fully responsible and accountable to clients for the activities of their agents.

Verbal Disclosure

Both the Banking and Insurance industries have expressed concerns over their call centres experiencing issues with verbal disclosure over the phone. There is a high drop out rate as

callers were simply hanging up when met with the verbal disclosure requirement. In this regard, ASIC has been applying the law regarding verbal disclosure as flexibly as possible, but we acknowledge that this is a matter that may require law reform and as such has been raised with the Government. We understand that both the banking and insurance industries would like to give callers the option of opting out of hearing the required disclosure statements.

LOOKING TO THE FUTURE

It is ASIC's intention to continue to influence behaviour and facilitate business using non-enforcement means, including by pursuing and implementing policy that considers both commercial imperatives as well as legal obligations, issuing policy guidance to and liaising with business, maintaining public databases and educating business and consumers of their rights and obligations.

Expanding our role in this regard is an important and deliberate focus for the organisation. However it should not be considered a shift away from ASIC's activities in respect of enforcing the law. Rather, it is our aim to see both roles undertaken concurrently, with ASIC's positive impact on business facilitation further enhanced over the coming years.

Consumer protection will also feature high on ASIC's agenda. As well as using our surveillance and enforcement powers to deter misleading and unconscionable conduct in relation to financial services, the Commission will seek partnerships with various consumer and other organisations to improve the targeting of our consumer education. We will continue to provide guidance to consumers through our publications and 'FIDO' website and will also continue to produce relevant reports such as the recent report on soft dollar commissions.

Consumers are not all alike and it is not possible to have a single approach to education across the myriad of financial services and products. We believe that in order to be successful, a consumer education campaign must be capable of being targeted directly and effectively. In other words, we need to ensure that the message gets to those who need it most, at the time they need it most and in a manner that will have the greatest impact in ensuring consumers full consideration.

Superannuation Choice of Funds

We anticipate that one of our greatest consumer protection challenges over the next 12 months will be the education campaigns in the lead up to the commencement of Super Choice of Funds legislation on 1 July 2005. Choice of Fund will enable employees to choose where they place their superannuation and will potentially generate an increased amount and range of financial services activity.

We anticipate that about another 5 million people will be given the opportunity to make a choice of fund, on top of those that already have Choice of Fund either under State legislation or because the employer voluntarily offers it. If even 20% only exercise their right to contribute to a different fund than they do currently, this amounts to 1 million consumers we are trying to reach.

It is expected that much of the change will be between the major sectors (rather than within sectors) with industry funds battling to retain members in the face of competition from the retail sector and with retail funds trying to pick up new members wherever they can.

This means there is likely to be greater demand for financial advice as well as greater "selling" of financial advice. The standard choice form, advertising, direct mail (and other communications with employees) are all likely to emphasize the importance of getting advice. Employees, faced with a choice of fund for the first time, might seek out the help of a financial adviser, accountant or other adviser (eg. bank employee, mortgage broker) that they already have a connection with; seek out an adviser for the first time or seek assistance from elsewhere (eg. employee association). There may be new entrants into the financial advice business or greater efforts to leverage of other people (via referrals) who may come into contact with employees (eg. bank employees, mortgage brokers, employee associations or unions) as an entry point for advice services.

An advertising blitz is expected in the face of what is likely to be fierce competition for the consumer dollar, between funds. Advertising may not only lead to the impact on the fees charged to members, but will also need to be monitored for misleading statements.

Apart from advertising via television, radio or print media, direct mail activity is likely to increase with banks, life offices, credit card providers or other financial services participants contacting their client base. Reliance on brand, incentives, special offers or additional incentives might be a feature of direct mail.

We are also likely to see consolidation of funds and there may also be other changes to the structure and nature of superannuation offerings (eg type of insurance, extent of insurance) driven by the Choice legislation, that may have disclosure ramifications.

It is a huge consumer protection challenge and consequently we are looking to commence consumer campaigns at the earliest opportunity.

Banking and EFT Codes of Conduct

Finally, a quick run down on the Banking and EFT Codes of Conduct.

Notwithstanding the comprehensiveness of the FSR reforms, we believe the financial industry Codes remain an important part of the Australian regulatory environment in dealing with specific and identified consumer protection issues not covered by the legislation. They can also play a role in elaborating or building on the broad legislative requirements.

While acknowledging that under the FSR framework there is no capacity to mandate participation in a financial services' industry Code, we do encourage those banks that are yet to subscribe, to do so. ASIC believes it is important that the retail banking industry is seen to be united in its efforts to improve the customer-banker relationship.

The EFT Code of Conduct has also been in existence for many years. The latest version, which became effective in 1 April 2002, extended the scope of the Code to virtually the full range of fund transfer transactions effected electronically. The next Review of the EFT Code will commence later this year. ASIC will be launching this review with an issues paper. It will identify issues thrown up by technological and market place developments since the Code was last reviewed. These issues will include those surrounding electronic funds transfer fraud perpetrated against Australian consumers. The review is also likely to canvass whether the code is the right vehicle for addressing some of these EFT related issues. We will be consulting publicly throughout the review.

Conclusion

It will be interesting to reach the point where we are able to review the full impact of FSRA, and to see how the legislation has tracked against its original objectives. To the extent that the improved regulatory regime helps maintain our position as a leader in international regulation, thereby attracting business, ensuring market competitiveness and integrity and offering

enhanced consumer protection, we can not object to the regulatory changes being introduced. We believe it will result in an even more compliant and competitive financial services industry and to this end we encourage you to embrace the changes and apply the new regimes to your and your clients benefit.